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Business Combinations under Common Control
Issues Paper

Objective

1 The objective of the session is to prepare for the July 2018 meeting of the Accounting Standards Advisory Forum (ASAF) by receiving EFRAG TEG and EFRAG CFSS members' comments on:

(a) The measurements approaches being developed by the IASB staff to account for a transfer under common control within the scope of the IASB project on Business Combinations under Common Control (BCUCC); and

(b) The findings of the HKICPA and OIC joint investor survey on mergers and acquisitions (M&As) with third parties and M&As under common control and assess whether those M&As have different underlying substance.

Background

2 The IASB is planning to issue a discussion paper on transfers of a business or entity under common control in the first half of 2019. Currently, such transactions are outside the scope of IFRS 3 *Business Combinations*.

Scope of the BCUCC project

3 The IASB has tentatively decided that the scope of the BCUCC project should consider transfers of a business as defined in IFRS 3 and group restructurings under common control in which a reporting entity obtains control of one or more businesses, regardless of whether IFRS 3 would identify the reporting entity as the acquirer if the requirements in IFRS 3 were applied to the transaction.

4 The scope of the BCUCC project was clarified to include transactions that are:

(a) preceded by an external acquisition and/or followed by an external sale of one or more of the combining parties; or

(b) conditional on a future sale such as in an IPO.

5 The BCUCC project addresses the financial reporting from the perspective of the receiving entity.

Measurement approaches

6 Currently, the IASB staff is developing possible approaches for the receiving entity to measure acquired assets and liabilities in a BCUCC as follows:

(a) historical cost approach;

(b) current value approach; and

(c) predecessor carrying amounts.

Historical cost approach

7 Under the historical cost approach, the receiving entity will allocate the consideration across the acquired assets and liabilities (e.g. based on their relative fair values) without recognising goodwill.

8 If equal or higher value is given up in a BCUCC, the historical cost approach would result in recognising acquired net assets at amounts higher than both the pre-combination carrying amounts and fair values of those net assets; and consequently:

(a) an impairment test would have to be performed and which would likely result in the recognition of an impairment loss;

(b) the accounting will not reflect the fact that equal or higher values are given up.

9 If higher value is received in a BCUCC, the historical cost approach would result in recognising acquired net assets at arbitrary allocated amounts without reflecting the fact that a higher value is received.

Question for EFRAG TEG and EFRAG CFSS

10 Do EFRAG TEG and EFRAG CFSS consider that a historical cost approach provides the most useful information to the primary users of the receiving entity's financial statements at a cost that would be justified by the benefits? If the answer would be different for different types of primary users (non-controlling shareholders, lenders and creditors, the controlling party, prospective capital providers), please explain for which users the information would/would not be useful.

Current value approach

11 Under the current value approach, the receiving entity will reflect acquired assets and liabilities at their current values (e.g. at fair values). Goodwill is measured as a residual.

12 The application of the current value approach to BCUCC would result in:

(a) recognising acquired identifiable net assets at fair values;

(b) recognising goodwill that comprises both internally generated goodwill and any combination synergies;

(c) outcome that would be consistent with IFRS 3 *Business Combinations*; and

(d) reflecting the actual values exchanged.

13 Additionally, when higher value is given up, the current value approach would recognise as a distribution the excess of the fair value of the consideration transferred over what a market participant would pay for the acquired interest. When a higher value is received, the current value approach would recognise as a contribution the excess of what a market participant would pay for the acquired interest over the fair value of the consideration transferred.

14 At its June 2018 meeting, the IASB considered possible current value approaches and agreed to further explore whether and how the acquisition method set out in IFRS 3 should be modified for BCUCC to provide the most useful information about BCUCC that affect non-controlling shareholders. The possible modifications could include requirements for the receiving entity to:

(a) provide additional disclosures;

(b) recognise any excess identifiable net assets acquired as a contribution to equity, instead of recognising that excess as a gain; or

(c) recognise any excess consideration as a distribution from equity instead of including it implicitly in the initial measurement of goodwill. The excess consideration could be measured, for example, by either:

   (i) Comparison with the fair value of the acquired business (so called 'ceiling approach'). This method would mean that synergies with the acquirer will not be included in goodwill; or

   (ii) By applying the mechanics of IAS 36 *Impairment of Assets* (so called revised ceiling approach'). The latter approach would mean that goodwill is calculated in accordance with IFRS 3 and tested for impairment at acquisition date by applying the mechanics in IAS 36 to identify any distribution. The recognised goodwill might comprise both internally generated goodwill and combination synergies. Any excess of the carrying amounts of the CGU(s) to which the provisional carrying amount of goodwill has been allocated over the recoverable amounts of those CGUs results in adjusting the provisional carrying amount of goodwill and recognising a distribution from equity.

Questions for EFRAG TEG and EFRAG CFSS

15 Do EFRAG TEG and EFRAG CFSS consider that a current value approach provides the most useful information to the primary users of the receiving entity's financial statements at a cost that would be justified by the benefits? If the answer would be different for different types of primary users (non-controlling shareholders, lenders and creditors, the controlling party, prospective capital providers), please explain for which users the information would/would not be useful.

16 Do EFRAG TEG and EFRAG CFSS agree that any excess fair value of identifiable net assets acquired over the fair value of the consideration transferred should be recognised as a contribution to equity, instead of as a gain in the statement of profit or loss? If you disagree, please explain.

17 Do EFRAG TEG and EFRAG CFSS consider that the acquisition method should be further modified to reflect any excess consideration as a distribution from equity? If so, would you prefer using the ceiling approach or the revised ceiling approach?

18 What disclosures should be required about BCUCC in addition to disclosures already required by existing IFRS Standards?

Predecessor approach

19 Under the predecessor approach, the receiving entity will reflect acquired assets and liabilities at their predecessor carrying amounts (e.g. the carrying amounts reflected in the transferee's financial statements).

20 When equal or higher value is given up in a BCUCC, the application of the predecessor approach would result in:

(a) recognising acquired net assets at their pre-combination carrying amounts;

(b) recognising as a distribution the excess of the consideration transferred over the pre-combination carrying amounts of net assets. Hence the accounting will not reflect the fact that equal or higher value is given up.

21 When higher value is received in a BCUCC, the application of the predecessor approach could result in:

(a) recognising a **contribution**, if the consideration transferred is less than the pre-combination carrying amounts of net assets; or

(b) recognising a **distribution**, if the consideration transferred is more than the pre-combination carrying amounts of net assets, even though it is below the value received.

Question for EFRAG TEG and EFRAG CFSS

22 Do EFRAG TEG and EFRAG CFSS consider that information that can be used for assessing whether or not the transfer price is "right" is the most important/only criteria that should considered when deciding on how to account for BCUCC?

23 Do EFRAG TEG and EFRAG CFSS consider that a predecessor approach provides the most useful information to the primary users of the receiving entity's financial statements at a cost that would be justified by the benefits? If the answer would be different for different types of primary users (non-controlling shareholders, lenders and creditors, the controlling party, prospective capital providers), please explain for which users the information would/would not be useful.

HKICPA-OIC joint investor survey on M&As

Background of the survey

24 Between August 2017 and February 2018, the HKICPA and the OIC jointly conducted an online investor survey on M&As that are common both between third parties and parties under common control.

25 The survey aimed at:

(a) understanding whether investors consider that M&As with third parties and M&As under common control have a different underlying substance; and

(b) exploring the factors that could indicate the difference in the underlying substance.

26 The findings of the survey would also provide an input to the IASB research project on BCUCC with respect to whether all M&As should be accounted for in the same way, if the underlying substance is the same.

27 The investors survey contained 5 questions:

(a) Question 1 and Question 2 requested information on the background of respondents;

(b) Question 3 asked whether respondents consider the substance of an M&A under common control different from that of an M&A with third parties. Respondent who gave answer 'No' to Question 3 were not required to answer Question 4 and Question 5;

(c) Question 4 included an illustration of an M&A with a third party and Question 5 included an illustration of an M&A under common control. Both questions asked respondents to identify the factors that are important to evaluate the substance of these M&As.

28 Half of all respondents were institutional and retail investors. The remaining half included analysts in various capacities.

Findings of the investors survey

29 The findings of the joint investors survey of the HKICPA and the OIC are the following:

(a) the majority of respondents perceived that M&A under common control may be different from M&A with third parties;

(b) however, when evaluating the factors that could indicate those differences, respondents indicated that some factors are important in both situations. Such examples include situations where M&As are expected to bring material changes to acquirer's future cashflows or to turn the acquirer from loss-making to profit-making; or when consideration for the acquired business is at fair value. This implies that from the investors' perspective, M&As under common control could have similar or the same substance as M&As with third parties when these factors are present in the M&A under common control;

(c) some factors were considered more important for determining the substance of M&As under common control than for M&As with third party e.g. when the purpose of the acquisition is to achieve tax benefits for the group; and

(d) the synergies arising from M&As and M&As at fair values are strongly considered by investors when evaluating the substance of the transaction.

30 The survey findings indicated that further outreach is necessary to understand why some factors are considered more important than other factors for M&A under common control and whether similar information is required by investors for M&As under common control which has similar substance to M&A with third party and M&As under common control which are not similar to M&As with third parties.

31 Finally, the survey findings may be considered limited and not representative of the general investor community based on the number of responses received.

Question for EFRAG TEG and EFRAG CFSS

32 Do EFRAG TEG and EFRAG CFSS have any comments on the findings of the HKICPA-OIC joint investors survey on understanding the substance of M&As and factors affecting this substance?

Agenda Papers

33 In addition to this issues paper, agenda papers for this session are:

(a) Agenda paper 09-02 – ASAF 06 BCUCC – measurement approaches – for background; and

(b) Agenda paper 09-03 – ASAF 05 BCUCC – joint HKICPA-OIC investor survey - for background;

(c) Agenda paper 09-04 – ASAF 06A BCUCC – update on the June 2018 IASB meeting – for background.